Mitigating the risk

In-house Congress Singapore

Top management, corporate counsel, CFOs, internal audit, HR and security executives must act in concert and understand the risks of not checking the background of new hires, vendors, distributors and business partners. This basic failure in due diligence and corporate governance can cause and has led to massive losses for many multinationals in China.

Pacific Business Press hosted the sixth annual In-House Congress Singapore at the Grand Hyatt Singapore on Tuesday, 22 February, bringing together 200 in-house counsel from leading domestic and international companies in Southeast Asia. This year's event addressed critical, sensitive and strategic issues facing businesses in the region and was opened with a revealing address by Peter Humphrey, founder of ChinaWhys Company Limited, on the theme of 'Managing the Risks of Fraud and Corruption in China Business Operations'. A thought leader in the area of China business risk, Humphrey has spent almost 30 years focused upon China and other communist states. His firm has assisted leading multinationals to identify, manage and reduce risks in their China operations and to prevent and investigate fraud and employee corruption, a growing problem in the country.

Humphrey began his presentation by highlighting the 'quantum shift' in the world supply chain of recent years that now appears to be inducing every company in the world to shift their manufacturing base to China. Some key trends as part of this shift – more outsourcing, localisation and technology transfer – were driven by understandable cost-benefit logic but dramatically raised the risks facing the corporations' supply chain integrity, profitability and brand reputation. Many firms had neglected this and had not followed best business practices for mitigating risk in China, and had consequently paid dearly.

In one case, Humphrey described how a multinational manufacturer of vehicle components had hired a bright young local into a senior role in its China business and he had secretly set up a side business run by his family which he grew into a major competitor of his employers, inserting his factories into the multinational's supply chain, copying their technology, know-how and management systems, and then hijacking their original equipment manufacturer (OEM) clients, all without the multinational knowing until it was too late. The man's firm is now preparing an IPO.

In another study of poor practices, Humphrey described how corrupt merchandisers at the China sourcing office of a multinational garment brand had taken advantage of lax business controls and China's restrictive export licensing, to gain control of supplier relationships and extract millions of dollars in bribes and kickbacks from the suppliers, while compromising quality controls and corporate social responsibilities. The discovery of large-scale abuses led to a wholesale purge of corrupt staff.

Humphrey also provided a vivid description of how employees in virtually every department of a well-known hygiene products manufacturer had colluded with a counterfeit syndicate to produce fake goods and inject them back into the multinational's own sales and distribution channels, bringing a mix of genuine and fake products into the firm's own warehouses. The head of R&D was a shareholder of the syndicate and played a starring role in the scam, regularly passing out product updates, Humphrey said.

He also related how a senior buyer in a well-known supermarket chain had set up phantom suppliers that she and her mother and boyfriend secretly owned, along with taking illicit commissions and kickbacks from other vendors, and thereby creamed some 30 percent off every transaction. Her boyfriend had even been supplying smuggled goods, which made the company potentially vulnerable to a customs raid. And one of the suppliers had provided fake goods made by the counterfeiters in the previous case study, which led to an embarrassing anti-counterfeit raid.

Humphrey argued that multinationals often neglect preventive risk management measures in China, believing 'it cannot be done' here or in order to avoid the cost. He said they often ended up paying a much higher price later – for troubleshooting remedies when things went wrong.

Humphrey believes these key managers in the organisation need to coordinate and adopt an integrated set of risk management measures to protect the company's bottom line and reputation.

There are steps that can be taken to avoid the horrors that he described in his case studies occurring. These included systematic and independent reference checks and pre-employment screening, vetting of suppliers, investigative due diligence on the people who run your joint venture partners and acquired firms, solid corporate security and IT policies, up-to-date contingency plans and crisis management procedures, the implementation of a strong code of conduct reinforced by ethics awareness training, the adaptation of business controls to make them more effective in the Chinese environment, restrictions on the hiring of relatives, and special efforts to bridge the inter-cultural communication gap.

Ultimately, the lesson in all fraud cases like those he outlined, and there was potentially one at every major multinational operating in China, was that they could have been prevented by best practices.

'It pays to provide resources for risk management from day one,' Humphrey commented. 'Not as a cheap afterthought when the horse has already bolted from the barn. Immediately installing strong controls and implementing them visibly will help prevent enormous potential costs and failures in the future.' **AC**

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